THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 264 **April 1995**

The Fed Abdicates

"Commercial and financial crises are produced, not by over-production, but by over-consumption."

Principles of Social Economy
Yves Guyot, 1884

The dollar's woes continue to multiply, yet Wall Street remains amazingly indifferent to its plight. Consensus opinion continues to predict renewed bull markets in stocks and bonds. There even is widespread praise for the Federal Reserve and its stubborn unwillingness to defend the world's key reserve currency. How are we to explain this stunning complacency?

We begin with an analysis of the forces driving down the dollar and the other weak currencies. In our view, the U.S. dollar – like the Spanish peseta, the Mexican peso and the Canadian dollar – is the victim of a structural debt crisis now unfolding in the global financial markets. This marks the inevitable end to the years of overborrowing and overconsumption by the big debtor countries. The day finally has arrived when foreign capital flows no longer are sufficient to sustain their enormous balance-of-payments deficits.

Unable – or unwilling – to see the danger to the U.S. economy, Wall Street continues to treat the dollar collapse as an irrelevant side show, out of step with healthy U.S. fundamentals, in particular with moderate rates of producer and consumer price inflation. The currency markets, we are told over and over again, simply are overshooting.

This is rubbish. In fact, we would say that by holding the dollar at relatively stable levels in recent years despite the steadily worsening U.S. current-account deficit, the currency markets already have overshot – but in the direction of unjustified dollar strength, not weakness. This is the mistake they are now rectifying.

We see two fundamental reasons for the dollar's collapse. First, we would blame the Fed. Through its long-standing tendency towards monetary laxness, it has fundamentally altered the basic structure of the U.S. economy. The result has been a chronic excess of domestic demand over domestic production, and a structural current-account deficit.

Second, the pool of surplus global savings available to finance that deficit has dwindled. Japan's brutal liquidity crunch has crippled its financial institutions, rendering them incapable of exporting capital on the scale necessary to recycle Japan's enormous current-account surplus. In Germany – the other big surplus nation of the 1980s – the demands of reunification have absorbed previously excess savings.

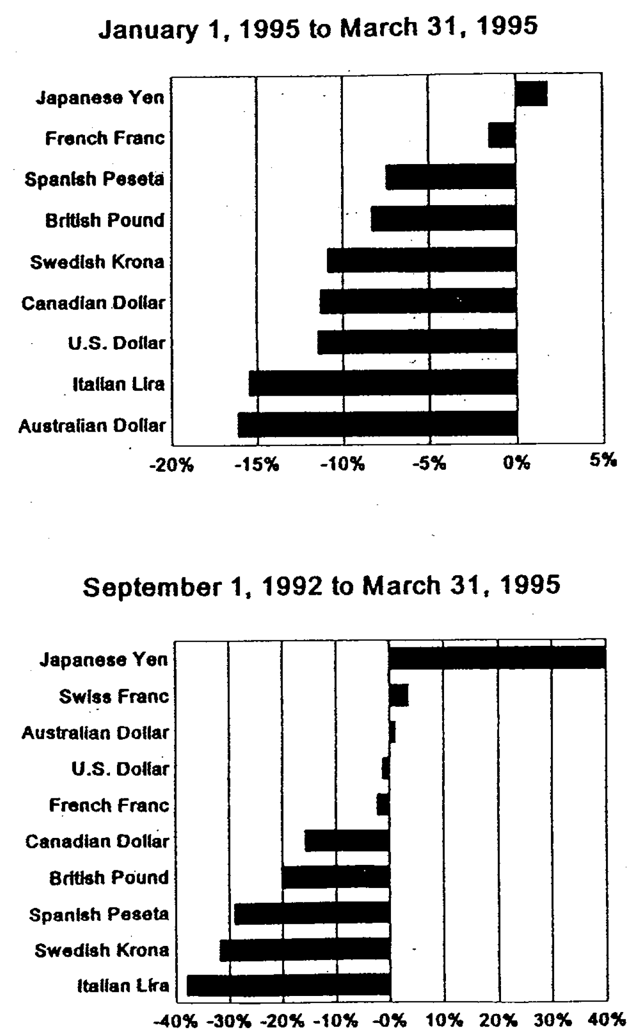
We see no group of nations capable of replacing Japan and Germany as the world's primary capital exporters. For the deficit countries, this makes a painful adjustment inevitable. But we see no signs that either the Fed or U.S. political leaders are willing to impose the required fiscal and monetary austerity. Accordingly, we see no bottom to the dollar's decline.

We can only wonder how long it will be before the dollar's relentless plunge finally breaks the current bullish mood on Wall Street. In the end, we think a resumption of 1994's bear market is inevitable.

CURRENCIES IN CHAOS

Defying the customary, annual bullish forecasts, the U.S. dollar has plunged to all-time lows against the yen, the DM and the Swiss franc. At the same time, the European Monetary System has fallen apart into two distinct groups: a shrinking DM bloc consisting of Germany, Austria, and the Benelux countries, and the remaining group of countries with more or less plummeting currencies.

The speed and scale of these exchange-rate movements are without precedent, at least in terms of the broad swathe of currencies affected. At times, it has looked like an outright free fall. In Europe, the Italian lira, the Spanish peseta, the British pound and the Swedish krona have suffered the big losses, adding to the substantial devaluations of those currencies since September 1992. Outside Europe, the big losers have been the Mexican peso and all three dollars – U.S., Canadian and Australian.



Change in the Value of Major Currencies vs. the DM

Though the market's focus in particular has been on the U.S. dollar, this obviously is not just a dollar crisis. It's a global currency crisis. This raises several essential questions:

- Why is it global crisis? Is it just another speculative binge? Is there one, common cause hitting all the vulnerable currencies around the world, or are these just a confluence of individual accidents?

- Where is all this going to end? Are we about to see the bottoms of these currency crashes, or is there more to come?

Reading and hearing many comments, we notice above all a general refusal to take this currency turmoil seriously as both a symptom and a warning of deeper-seated troubles in the global economy.

Complacent as ever, Europe's politicians have both an excuse and a scapegoat for Europe's latest currency mess. The excuse is the wave of political jitters now plaguing France, Britain, Italy and Spain. The scapegoat, as in past ERM crises, is the chronically weak dollar, which is said to be roiling world markets and dragging the weaker currencies down against the DM.

But we would say the weak European currencies are vulnerable because of their own monetary and fiscal policies, which have seriously imbalanced the economies of those countries.

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (March 31)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	-0.7%	-0.3%	-7.1%	-10.6%	4.6%
Canada	4.6%	2.4%	-0.4%	- 2.8%	8.9%
France	4.7%	-1.2%	- 10.7%	-15.3%	8.0%
Germany	-8.5%	-8.7%	-9.9%	-15.3%	0.6%
Hong Kong	3.1%	4.8%	-4.9%	-15.5%	23.2%
Japan	-5.4%	-18.2%	-15.6%	-25.1%	2.5%
Mexico	18.3%	-22.9%	-24.0%	-35.9%	26.6%
Spain	-3.1%	-5.1%	-16.0%	-20.0%	2.3%
U.K.	4.3%	2.4%	1.7%	-3.9%	9.1%
U.S.	2.7%	9.0%	12.3%	-0.6%	14.1%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (March 31)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	9.83	-2	-16	188	-88	188
Canada	8.60	8	-48	61	-108	70
France	7.90	-10	-37	143	-53	144
Germany	7.19	-17	-43	86	-57	95
Japan	3.68	-71	-89	-57	-128	0
Spain	12.32	51	48	334	-24	352
U.K.	8.42	-5	-10	73	-38	76
U.S.	7.20	0	-62	46	-83	46

Exchange Rates

Versus U.S. Dollar, % Change

Country (March 31)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.36	-0.7%	-5.4%	6.0%	-5.9%	4.2%
Canada ($)	1.40	-0.6%	0.2%	-1.1%	-4.3%	1.8%
France (*f*)	4.80	6.6%	10.7%	16.1%	0.0%	18.4%
Germany (DM)	1.37	6.2%	11.5%	18.1%	0.0%	20.1%
Japan (¥)	86.6	10.5%	13.1%	15.8%	0.0%	17.9%
Spain (Pt)	126.1	1.6%	4.1%	7.6%	-1.7%	9.8%
U.K. (£)	1.62	2.4%	3.6%	9.3%	-1.1%	10.8%

What, then, lies behind the rout of the dollar? Ever since the beginning of last year, the U.S. currency has done nothing but disappoint rampant bullish expectations – even though U.S. short-term rates have risen sharply against falling German rates. Oddly, this optimism persists, even as the dollar sinks to progressively lower levels.

So far, there seems to be more perplexity than anxiety about the dollar's unexpectedly steep decline. Given its rise against the Canadian dollar and the Mexican peso, many even deny the U.S. currency has dropped at all, at least not on a trade-weighted basis. At any rate, the majority view seems to be that the dollar's tumble is in flagrant contradiction to the U.S. economy's present excellent health. This raises the timeless question: What are the relevant economic fundamentals for the strength of a currency?

MEXICO IS NOT THE PROBLEM

Failing to see any deeper-seated causes for the dollar's weakness, the bulls have fixated on the U.S. rescue package for Mexico. We, on the other hand, would say that while the Mexican crisis may have been the catalyst for the dollar's latest plunge, it was hardly its true cause.

The dollar's long-term problem, simply stated, is that foreigners – already laden with dollar assets – are being forced by the U.S. current-account deficit to accumulate dollars at a rate of over $150 billion a year, far faster than they desire. That the Mexican crisis could have such a devastating impact on the dollar only confirms its inherent weakness and vulnerability.

It says everything to compare the one-time U.S. transfer of $20 billion to Mexico with the fact that the German government is pumping more than $100 billion a year into East Germany – without suffering any lasting structural damage to the DM. This is true even though much of the money poured into the east is quickly shifted into foreign hands by easterners, who have developed a strong taste for imports and foreign travel.

What, then, are the truly critical economic fundamentals that determine the long-term strength of a currency? For many years, it was a standard argument that the U.S. dollar was grossly undervalued in terms of its external purchasing power, when compared to the DM and the yen. However, as the dollar keeps getting ever more undervalued through its continuous fall, this so-called purchasing-power-parity argument has pretty well been consigned to oblivion, even by the dollar bulls.

Nevertheless, the fact remains that most people are completely mystified by the dollar's plunge. There still is a widespread feeling that the dollar should be strong because the U.S. economy has performed so much better in recent years than the German or the Japanese economies. The arguments are that the United States has had more rapid growth, associated with strong employment and productivity gains. Corporate operating profits are at their highest level in more than two decades. U.S. financial markets have been booming. Unit labor costs are rising at the slowest pace since the 1960s.

While the big U.S. budget and current-account deficits don't quite fit into this rosy picture, they are widely pooh-poohed with the contention that by international standards they constitute only a small share of U.S. GDP, and thus can be financed easily. U.S. debt orgies – both past and present – are dismissed with the argument that total U.S. debt now is growing at a rate of just 5% per year, a shadow of the excesses of the 1970s and 1980s.

Later in this letter, we shall explain in detail why all these bullish arguments are ill-conceived. But central to our bearish assessment of the dollar is one specific economic fact: the huge, chronic U.S. current-account deficit.

Just for a start, consider some of the numbers: Last year, the U.S. current-account deficit amounted to $156 billion. Over the past five years, it has totaled $426 billion. And over the past 13 years – since the string of unbroken U.S. deficits began in 1982 – the cumulative shortfall adds up to more than $1.2 trillion. This constitutes an enormous flow of dollars out of the U.S. money supply and into the hands of foreigners.

A RETURN TO ECONOMIC REALITY

It is an empirical fact that deficit countries normally have weak currencies and high interest rates, while surplus countries have strong currencies and low interest rates. Indeed, this once was regarded as an economic truism.

A high U.S. current-account deficit means, in the first place, that the United States is continuously feeding excess dollars into the rest of the world. This is bound to put downward pressure on the dollar's price. But such a persistent, large current-account deficit itself is but a symptom of a seriously imbalanced economy. The causes of this imbalance need exploring.

Historically, current-account deficits always have had the stigma of mirroring monetary looseness and an over-expansion of credit in the countries concerned. The popular view used to be that such countries were living beyond their means. As long as the markets retained this highly critical opinion of the nature of current-account deficits, such deficits, though frequent, remained relatively small and short-lived. Even minimal trade deteriorations tended to alarm the markets, forcing governments and central banks to prompt counteraction. Under the gold standard, in fact, monetary policy largely was guided by changes in the balance of payments.

This brings us to a crucial difference of opinion between American and European economists about the relationship between current-account deficits and inflation. In America, inflation is traditionally identified with a sustained rise in consumer or producer prices. If those prices are not rising, then by definition there is no inflation. Seen in this light, current-account deficits have nothing to do with inflation.

In the traditional European view, by contrast, current-account deficits and price inflation virtually are on par with each other in reflecting a common cause, namely an excess of domestic spending over domestic output. This, in turn, implies a loose monetary policy and excessive credit creation. Essentially, rising prices and rising imports are two separate ways that excess demand can manifest itself. Imagine what would have happened if a large part of the voracious demand for goods that has fueled U.S. import growth in recent years instead had fallen on domestic production. The result would have been rampant inflation in the U.S. price indexes. In short, U.S. inflation has been exported to the rest of the world, via the current-account deficit.

Balances on Current Account as a Percentage of GDP

Selected Countries

	Germany	France	Britain	Italy	Spain	USA	Canada	Australia	Japan
1980	-1.7%	-0.6%	1.2%	-2.3%	-2.4%	0.1%	-0.4%	-2.7%	-1.0%
1985	2.6%	-0.1%	0.6%	-0.9%	1.6%	-3.1%	-1.3%	-5.4%	3.6%
1986	4.4%	0.2%	-0.2%	0.3%	1.7%	-3.5%	-2.8%	-5.5%	4.3%
1987	4.1%	-0.6%	-1.2%	-0.3%	0.0%	-3.7%	-2.8%	-3.8%	3.6%
1988	4.3%	-0.5%	-3.5%	-0.8%	-1.1%	-2.6%	-3.5%	-4.1%	2.7%
1989	4.9%	-0.6%	-4.4%	-1.4%	-2.9%	-2.0%	-4.1%	-6.3%	2.0%
1990	3.1%	-1.3%	-3.4%	-1.6%	-3.4%	-1.7%	-3.8%	-5.1%	1.2%
1991	-1.1%	-0.6%	-1.3%	-2.1%	-3.2%	-0.1%	-4.1%	-3.5%	2.2%
1992	-1.1%	0.3%	-1.8%	-2.3%	-3.2%	-1.2%	-3.8%	-3.8%	3.2%
1993	-1.1%	0.8%	-1.7%	1.2%	-1.1%	-1.6%	-4.3%	-3.9%	3.1%
1994	-1.2%	0.7%	-0.9%	1.6%	-1.0%	-2.3%	-3.9%	-4.0%	3.0%

Source: OECD

But the markets' critical posture towards current-account deficits underwent a systemic change in the 1980s. In the face of the exploding U.S. external deficit, economists, particularly American economists, developed a new gospel that sang the praises of such deficits by arguing they were perfectly normal, if not an outright testament to the economic health of the deficit country. By pointing to the obvious fact that the current and capital accounts of any nation must be equal counterparts, the American revisionists were able to construct the argument that payments deficits are driven by strong investment demand for the currency in question, as foreign investors are drawn by the opportunity to earn superior rates of return in the deficit country.

It's hard to say to what extent this new, gleeful interpretation of current-account deficits lulled the financial world into a feeling of false security about exchange risks. In any case, beginning in the early 1980s, yield-hungry investors poured their money into the high-yielding currencies of the deficit countries on an unprecedented scale, completely oblivious to any exchange risk. As this meant that deficits were easily – in fact too easily – financed, deficits proliferated as never before.

In the European system of quasi-fixed exchange rates, this led to a preposterous result: For years, the countries with the biggest deficits and the highest interest rates also had the strongest currencies. And for years, we were a lonely voice in warning against this absurd trend, and the long-term currency risk it posed for investors.

But, our readers well may ask, why are our predictions at last coming true? Why are the dollar and the other weak currencies collapsing now? The table above takes us straight to the heart of today's global currency troubles.

The table should leave no doubt as to the root cause of the current crisis: A prolonged build-up of record-sized current-account deficits has resulted in an explosion of foreign indebtedness. Historically, currency crises always have been associated with payments deficits. It testifies to the poor judgement of the financial community that it failed to recognize the unsustainability of the present imbalances.

But accommodating chronic debtor nations requires that other nations play the role of creditors, disposing of their surplus savings and liquidity. During the oil shocks of the 1970s, the big increases in current-account deficits of the developing countries were financed – even overfinanced – through the recycling of oil revenues from the OPEC

countries. Western banks, primarily the big U.S. money-center banks, played an intermediary role, through their lending activities in the Third World.

Easy credit spared many a developing country from the need to adjust, but it also left them dependent on the vagaries of U.S. monetary policy. When U.S. monetary ease gave way to a savage squeeze in the early 1980s, bank lending dried up, and much of Latin America was driven into insolvency.

JAPAN AND GERMANY TAKE THE LEAD

In the second half of the 1980s, the role of the OPEC countries as the dominant international lenders was taken over by Japan and Germany. Owing to their high savings ratios and sharp cuts in government budget deficits, both countries began to experience exploding trade surpluses, which they used to finance rampant deficit spending by other industrial countries, particularly the United States. One important novelty associated with this change in global lenders was that the financing of current-account deficits increasingly shifted from bank lending to portfolio investment, primarily through the bond markets of the debtor countries.

In lending and investing their opulent surpluses, the Japanese and the Germans exhibited distinctly different regional preferences. Unlike OPEC, the Japanese showed little interest in Europe's traditional hard currencies. Reflecting their close economic and trade ties with the United States, Japanese banks and investors concentrated heavily on the U.S. dollar and, to a lesser degree, the Canadian and Australian dollars.

Conversely, the swelling German surplus was in large part recycled into other European countries and currencies. Taken in by their policymakers and bankers, who told them that economic and monetary integration in Europe practically was doing away with exchange risk, German investors became large-scale purchasers of the higher-yielding bonds of neighboring countries.

All in all, one may generalize that the Japanese eagerly over-accommodated spending excesses in the dollar bloc, while the Germans just as eagerly over-accommodated the same excesses in Europe.

In the end, Japanese and German investors both suffered terrible losses on their foreign investments because, implicitly, they carried the currency risks associated with those investments. This, by the way, marked the first time in history that lenders, rather than debtors, bore such risks. That this dismal experience eventually would put a brake on German and Japanese foreign investment should have been self-evident. But the drying up of capital flows has had yet another compelling reason. Investors not only are unwilling to lend – to a large degree they can't lend, due either to a lack of liquidity or a lack of savings. In Japan's case, a chronic lack of liquidity is the culprit; in Germany, it's a lack of savings.

Japan's excess savings, as reflected in its current-account surplus, soared last year to a new high of $131 billion, compared to an annual average of $71 billion between 1985-89. This would seem more than sufficient to fuel a new wave of global lending. But Japan's financial system has been paralyzed by the bursting of the bubble economy of the late 1980s, and the resulting collapse in land and stock prices. The dollar's steep fall has added to the damage by savagely depreciating the yen value of U.S. assets held by Japanese investors. All told, Japanese financial losses must run into the several trillions of dollars.

With the financial system too impaired to adequately recycle Japan's current-account surplus, the yen must rise. But as the yen rises, business profits are squeezed. This increases the pressure on Japanese stocks, and thus on the capital ratios of the major banks, which are allowed to count unrealized gains on their stock portfolios as part of their capital base. To shore up capital, the banks must either restrain credit, or sell whatever assets are not already under water. This further reduces their ability to recycle capital abroad, causing the yen to rise still higher.

All in all, this vicious circle has led to an enormous, persistent liquidity squeeze, making large-scale capital exports by the private sector virtually impossible. The only barrier left against a deflationary collapse is the Bank of Japan, which in essence has stepped in to fill the role of external creditor through its continued, huge dollar purchases.

In the case of Germany, the abrupt stoppage of capital outflows was just as compelling, though for a totally different reason. It was unification which abruptly turned the German current account from a huge surplus of $57 billion in 1989 into annual deficits running in recent years in the range of $20-30 billion.

We have undertaken this review of recent international capital flows in order to bring home the fact that Japan and Germany, the predominant global capital suppliers of the late 1980s, are not longer able to fill that role. Even more importantly, we see no country or group of countries capable of taking their place as capital suppliers to the world. This, in our view, is what is squeezing all the big debtor and deficit countries, and battering their currencies. Continuing large external deficits must take their toll, now that the easy capital supply from abroad – that is, primarily from Japan and Germany – is gone.

THE REAL BUBBLES

We are well aware that this explanation of the recent currency crashes differs fundamentally from the prevailing view, which tends to speak of speculative bubbles forming in the DM, the yen and the Swiss franc as a result of a flight of capital in search of a safe haven. This flight is seen as irrationally ignoring the excellent fundamentals of the U.S. economy. This, of course, brings us back to our original question: What are the key fundamentals affecting a currency's strength?

But first, a clarification of semantics. By definition, the term bubble implies the heavy use of borrowed money to acquire certain assets, such as stocks, bonds or real estate. We think it obvious that neither the yen's nor the DM's rise has anything to do with this sort of speculation. Looking for over-borrowed currencies, we think the label best fits the U.S. dollar and the currencies of the other big debtor countries. Those are the bubbles now bursting.

Yet it seems to be the convenient consensus view among U.S. policymakers and on Wall Street that the dollar's slide against the yen and the hard European currencies really doesn't matter much, because the greenback is stable or strong against most other currencies, and especially against the Mexican peso and the Canadian dollar.

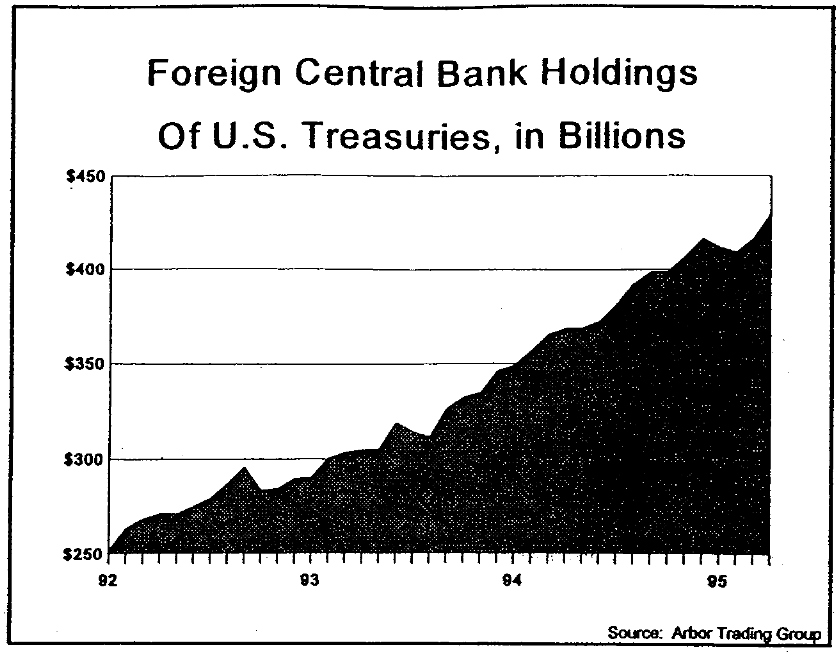
We find it more than a bit disturbing that the U.S. establishment now measures the dollar's strength against second-class and even third-class currencies. More to the point, the entire argument is completely phony. If not for massive dollar purchases by the central banks of the emerging countries, such as China, India, Malaysia, Singapore, Taiwan, Brazil and many others, the dollar would be skidding all around.

What's worse, the U.S. attitude strikes us as both cynical and short-sighted, especially when one takes into account the fact that the Europeans and the Japanese are by far the United States' main creditors. It really amounts to an open declaration of America's intention to cheat its lenders. For even if those investors stop buying additional dollars, they still are exposed to rising losses on their huge, existing dollar holdings.

Nevertheless, while Wall Street so far has ignored the dollar's plunge, we think there is a critical point down the road where a falling dollar will breed panic – both among foreign dollar holders and in the U.S. financial markets.

Actually, private foreign investment demand for dollars collapsed some years ago. If left strictly to the free play of market forces, the dollar would have plummeted in the early 1990s, and never recovered. Since that time, foreign central banks, particularly the Bank of Japan and the central banks of the Asian Tiger countries, have absorbed a steadily rising share of the dollar outflows generated by the U.S. current-account deficit.

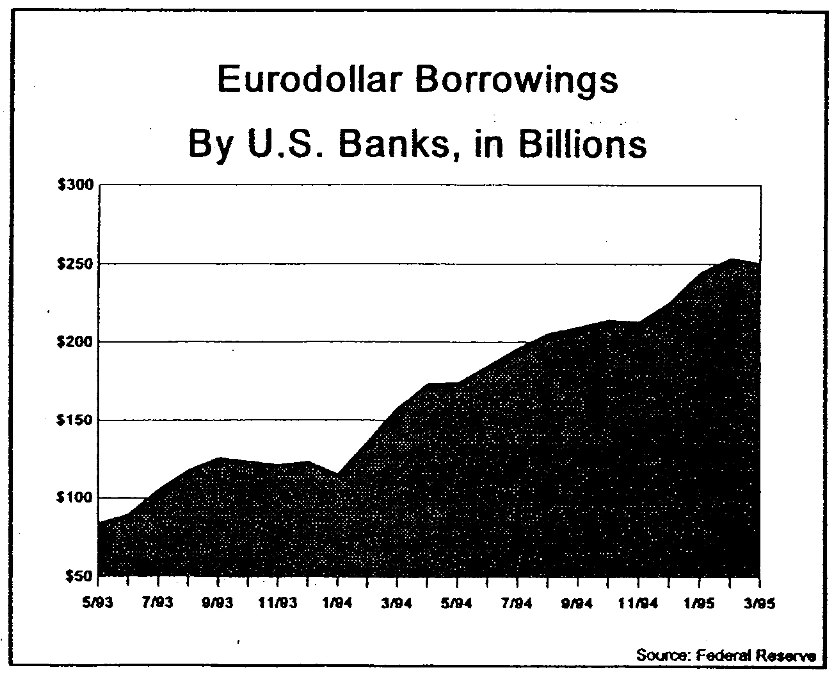
This support also has proven a key prop for the U.S. bond market. When foreign central banks buy dollars, they typically turn them over to the Fed for placement in custodial accounts. The Fed, in turn, invests those dollars in Treasuries. The amounts involved are staggering. Since the end of 1992, the Fed's custodial holdings for foreign central banks have jumped from $290 billion to $430 billion. Combined, those banks now own a bigger portfolio of Treasuries than the Fed itself.



This creates an obvious risk: Should the day come when those foreign institutions decide to reduce their dollar reserves, they will turn overnight from net buyers of Treasuries into net sellers. This would create enormous upward pressure on U.S. interest rates – probably at a time when the falling dollar itself is hammering the bond market.

The other chief source of funding for the U.S. current-account deficit has been record-high borrowing by U.S. banks in the Euromarkets. These rose by $100 billion in 1994, are presently increasing at about $10 billion per month, and now total about $250 billion. These short-term bank flows simply reflect the fact that as dollars exit the United States via the current-account deficit, they end up as Eurodollar deposits in offshore banks. The banks then seek to deploy those dollars into income-earning assets. At times of strong U.S. economic growth, this best can be done by lending dollars back to U.S. banks. While this leaves Eurodeposit holders with the exchange risk of a sliding dollar, that risk can quickly and easily be avoided by selling dollars, or by hedging in the forward markets. In short, Eurodollar borrowings are hot money, and as such, a potentially huge source of downward pressure on the dollar. In this light, the dollar's sharp fall of recent weeks seems to us particularly ominous.

The markets now face two key questions: How fast and how far will the U.S. currency fall? What has to happen to stop its fall? For the time being, the illusion prevails that since dollar weakness is at gross variance with U.S. economic fundamentals, the dollar must be poised for a sharp future recovery.



The trouble is that conventional wisdom is flat wrong on the question of what economic fundamentals really matter for a currency. Generally speaking, a currency falls when the outflows through the current and capital accounts exceed the simultaneous capital or credit inflows from abroad. In a word, the one and only decisive fundamental determining a

currency's strength or weakness is the underlying balance of payments. In this regard, two crucial factors are depressing the dollar:

- The huge gap in the U.S. current account, which is flooding the outside world with dollars.
- A pronounced weakening in the U.S. capital account, owing to the declining attractiveness of U.S. assets to foreign investors.

The salient point now is this: As long as large current-account deficits persist, we see no floor under the dollar. The U.S. deficit simply is too big to be financed by foreign investors, now that the former big surpluses of Japan and Germany no longer are available.

THE DEBT SYNDROME

In the last analysis, the crucial question is why the United States and the other debtor countries have such chronic, large current-account deficits. Oddly, this most important question is rarely posed and never investigated. After musing for some time over this issue, we have drawn quite bearish long-term conclusions.

In trying to uncover the root causes of the U.S. dollar's malaise, it is necessary to distinguish between the long-term structural maladjustments adversely affecting the U.S. economy's international competitiveness, and short-term or medium-term cyclical and monetary influences. Sometimes, the two compound; at other times they may offset each other. Presently, they compound.

We agree with the view that the evaporation of earlier expectations of future sharp increases in U.S. short-term rates has played an important role in pushing the dollar lower, and catapulting the DM higher. The Mexican crisis, to be sure, exacerbated this situation, by calling into question the Fed's willingness to stomach the financial turmoil that inevitably would result from further monetary tightening. But all this leaves unexplained why the U.S. economy is stuck with such large, chronic trade and current-account deficits, which we regard as the key forces depressing the dollar. These deficits are hard to reconcile with the view that the U.S. economy now is internationally hyper-competitive, owing to the grossly undervalued dollar.

Our short answer to this query is: U.S. corporations well may be leaner, fitter and more profitable than ever before – but they are obviously totally uncompetitive in terms of available manufacturing capacity. This is the critical shortcoming on the U.S. economy's supply side, because overall, the U.S. trade deficit is largely a deficit in the trade of manufactured goods.

In essence, what the chronic trade deficit signals is that the growth of domestic demand in the United States has permanently exceeded the growth of output, above all, the growth of manufacturing capacity and output. Manufacturing's crucial importance is that its output is internationally tradable, while most services are not. But how did this chronic spending-output gap come about? And what has to be done to correct it?

In the first place, to keep domestic spending in permanent, considerable excess over domestic output requires a monetary policy with a persistent inflationary bias. This the Fed has seldom failed to provide. For most of the past two decades, U.S. monetary policy has been far too easy.

But chronic monetary looseness has had still another important effect. It has led to considerable changes in the U.S. economy's demand and output structure. Debt-fueled overspending on consumption has had its inevitable counterpart in undersaving and underinvestment. Not only has fixed investment fallen to near a record low as a share of U.S.

GDP, but at the same time its composition has become increasingly ill-structured towards the retail and financial sectors. Manufacturing investment, by contrast, has been the weakest component of overall investment.

We posed the question of what must happen to curb and eliminate the outsized U.S. trade deficit – the necessary precondition for stabilization of the dollar. The first thing to realize that such a correction now is inevitable. The easy and generous financing of large trade and current-account deficits is definitely a thing of the past. At long last, the deficit countries have to adjust. More precisely, if the deficit countries want to prevent a free fall of their currencies, they have to eliminate the existing imbalance between their domestic spending and domestic output. After all, a nation cannot spend more than it produces forever. In short, America and all the other deficit countries need both monetary and fiscal tightening. The resulting increase in the supply of national savings would, in turn, help raise the share of investment in GDP.

Some deficit countries may accept this disciplining effect of the balance of payments. But we don't see it in the United States. We think the Fed always will try to muddle through with loose money.

It always has been hailed as a sign of economic health and a great bull factor for the U.S. financial markets that the current cyclical strong U.S. recovery has taken place without the usual acceleration in inflation. But this is yet another cardinal fallacy arising from the American tendency to focus exclusively on the price indexes for goods and services as both the sole symptoms and sole measures of inflation.

This narrow concept of inflation is theoretically unfounded. In principle, excess money and credit can spend itself in three different areas of the economy: consumer and producer prices, asset prices, or the balance of payments. In trying to measure inflationary pressures, it is necessary to look at all three aggregates.

Looking back at the debt orgies of the 1980s and the 1990s, not only in the United States but in many other countries, rampant inflation is all too evident. But the novelty that confused and misled many people, even the policymakers, is the fact that in many countries monetary inflation had its main effects in booming financial markets and exploding trade deficits, not in soaring consumer or producer prices. The other common feature of this general inflationary trend was overspending on consumption at the expense of savings and investment.

PRODUCTIVITY ILLUSIONS

It has been a popular argument among dollar bulls that the U.S. economy in recent years has experienced a "productivity miracle," speaking well for Corporate America's ability to rise to the global competitive challenge. The point commonly made is that U.S. productivity growth has averaged about 2% since 1991 – more than twice the 1978-87 average.

Considering the United States' continuing poor investment performance, we always have suspected that this improvement was mainly cyclical, not structural. Now we can cut the story short because even the recently published U.S. Economic Report of the President expresses doubts about a breakthrough in productivity growth. To quote:

"The evidence in support of a pickup in productivity growth is inconclusive. For example, if trends are computed for the periods 1978-86 and 1986-94, rather than 1978-87 and 1987-94, the suggestion of a pickup is much weaker: Productivity growth averaged 1.0% per year in the earlier subperiod and 1.1% in the later one.

"On the other hand, if the breakpoint chosen is 1988, or especially 1989, the evidence in favor of a pickup appears stronger. However, the averages over these later periods are dominated by the cyclical recovery and so may create a false impression of an improvement in the trend."

We started with the question of whether or not the dollar's steep decline is justified by the economic fundamentals. We would say it definitely is justified. The dollar is weak by the simple law of supply and demand.

The ultimate, decisive aggregate of the strength or weakness of any currency is the country's overall balance of payments – its current account plus or minus capital flows. In this respect, the key force depressing the dollar is the persistent outflow into the rest of the world through the huge current-account deficit.

The markets slowly have awakened to the recognition of three extremely negative facts for the dollar:

- The U.S. payments gap is likely to stay on the high side, if not to rise.
- Net capital inflows from abroad have dropped sharply and are insufficient to cover the current-account deficit.
- The Federal Reserve and the U.S. Treasury have no intention of mounting a serious defense of the dollar. Some U.S. officials even nonchalantly profess that the slumping dollar is the problem of the countries whose currencies are soaring.

As we have long maintained, the U.S. current-account deficit and the associated, rapid build-up of foreign debt are relentless long-term depressants of the dollar, and they are getting worse and worse. But what happens in the short term depends very much on the business cycle and on related changes in monetary policy. In this light, the dollar already was suspect last year, when it fell despite U.S. rate hikes and German rate cuts. To us, this signaled that any downward revision in market expectations of the future path of U.S. and German short-term rates would pull the rug out from under the dollar. And so it happened.

THE RECKLESS FED

The only thing about this dollar crisis that has taken us by surprise is that Fed chairman Alan Greenspan and other Fed officials would choose this critical moment of a falling dollar to give a major boost to speculation in bonds, stocks and foreign currencies, by emphasizing their readiness to ease on the first signs of a slowing U.S. economy. Such a declaration before the peak of a cyclical recovery really is unprecedented. If they wanted a collapsing dollar, they couldn't have devised a better way to ensure it.

Inevitably, we ask ourselves why they did this. We suspect they are terrified that any further rate hikes ultimately would prick the speculative bubble in the U.S. markets, with devastating effects on the over-leveraged financial system, leading to a recession that would coincide with the 1996 election season. This would be totally unacceptable to the politicians, from whom the Fed now appears to take its marching orders.

Even more surprisingly, the U.S. financial markets seem to regard the Fed's abdication of responsibility with joy, not foreboding. There is something quite extraordinary about this, given the markets' alleged sensitivity to even a whisper of inflation in the U.S. price indexes. We can think of two, complementary explanations. First, as we have explained, there is a general tendency in the United States to misread the inflation fundamentals, ignoring the effects of excessive credit expansion on asset prices and the trade balance.

But even taking this myopia into account, the markets' euphoria still is striking. With the latest reading on the U.S. economy, for the fourth quarter of 1994, registering growth in excess of a 5% annual rate, with the dollar collapsing, and with reported consumer price inflation in excess of 3% and clearly on a cyclical upswing, we would say the case for further Fed tightening is obvious. Yet Wall Street has rushed to embrace the so-called "soft landing" scenario, in which economic growth effortlessly slows to a 2.5% rate, with only a modest uptick in inflation.

How this miracle is supposed to occur at a time of massive dollar depreciation is a question that rather mystifies us. We can only say that Wall Street appears predisposed to believe in the absurd – the classic hallmark of a speculative mania. This should come as a warning to those who expect the U.S. financial markets to "discipline" American fiscal and monetary laxity. To a large extent, the markets are part of the problem, not the solution.

The lesson should be clear: The U.S. financial and political establishments both share a common addiction to cheap money. The Fed will not impose restraint. This amounts to an open invitation to the rest of the world to sell dollars.

CONCLUSIONS

The dollar's decline is a secular trend, spanning almost three decades, interrupted only during the early years of the Volker Fed. But the pace of the dollar's descent generally has been controlled by the fluctuations of the business cycle. In times of strong U.S. economic growth, the dollar has tended to strengthen. In recessions, it has slumped.

This is what makes the current plunge so alarming. The U.S. economy has grown strongly over the past year, yet still the dollar has collapsed. Clearly, structural forces have overwhelmed the normal cyclical trend.

We cannot predict when – or where – the dollar's current slide will hit bottom. Ordinarily, the currency of a deficit country could be expected to fall until capital inflows once again balance the outflow on the current account. This can occur through several mechanisms, including a reduction in imports, an increase in exports, or a rise in capital inflows, as foreigners conclude the currency has fallen too far, and is likely to appreciate in the future.

But for the dollar, we see major barriers to adjustment on all fronts. As we have explained, structural changes in Japan and Germany have permanently reduced the supply of global capital. In the case of Japan, the weak dollar actually is aggravating that shortage, by hammering Japan's already-crippled financial system. Boosting U.S. exports, or significantly cutting imports, on the other hand, would require a sharp monetary tightening to reduce domestic consumption. This the Fed is completely unwilling to provide.

This creates an enormous risk. The legacy of America's deficits is a massive accumulation of dollar-denominated assets in the hands of foreigners, totaling some $3 trillion. As the Fed's paralysis becomes obvious, the case for dumping these holdings becomes compelling. In the end, the result could be panic selling, and a dollar free fall.

For investors, we can only repeat our long-standing advice: Seek safety and liquidity in cash and short-term bonds of the hard-currency countries: Germany, Switzerland, Austria and the Netherlands.

THE RICHEBÄCHER LETTER

DR. KURT RICHEBÄCHER, Publisher and Editor.

Bill Montague, Associate Editor

For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 1129 E. Cliff Rd., Burnsville, Minnesota, USA 55337. Subscription orders may be placed toll free from inside the USA by calling **(800) 894-3424**. For all other inquiries, and to order from outside the USA, please call **(612) 894-4088**. Fax: **(612) 895-5526**. Subscription rates: North America, U.S. $400. Outside North America: U.S. $420, or DM 630. Published monthly.